

Morgan Stanley

INVESTMENT MANAGEMENT



# 27 February 2020 – Market Update: Coronavirus: seeking to protect GBaR portfolios from tail risk

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM | MARKET PULSE | 27 February 2020

Over the last week, the impact of the coronavirus (COVID-19)<sup>1</sup> has escalated substantially outside China, with confirmed cases in over 30 countries, most notably South Korea, Japan, Italy and some Middle Eastern countries. Although the virus is contagious and unlikely to be contained, we believe that the situation is still manageable as seen in the case of Singapore. In addition, COVID-19 appears to have a low mortality rate compared with SARS, while the situation in China seems to be improving. Finally, the outbreak of a pandemic virus is disruptive, but not destructive like a natural disaster. Therefore, it is reasonable to believe that global economic growth recovery could be delayed, but not derailed completely.

If we see further deterioration, we could see more monetary and fiscal policies globally from central banks and governments to combat the impact of the virus. Furthermore, the decline in financial markets could provide potential investment opportunities. That said, we will monitor the situation closely to identify the appropriate point at which to move back into risk assets, but we need to have evidence of stabilisation before we are comfortable making such a move.

In contrast to the short-term shock the virus may deliver to the global economy, longer-term growth may be more at risk from potential changes in US economic policy if a Democrat were to win the United States presidential election later this year. The impact would likely result in less business friendly policies such as the reversal of President Trump's tax cuts and further regulation. We believe that this outcome has yet to be priced in and the risk depends on how the US Presidential campaign develops from here.

More generally, looking through the virus impact we still expect the likely economic environment to remain benign - essentially non-recessionary, albeit with slow growth. However, we continue to see tail risk at elevated levels, which

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<sup>1</sup> World Health Organization (WHO), [www.who.int/emergencies/diseases/novel-coronavirus-2019](http://www.who.int/emergencies/diseases/novel-coronavirus-2019)

implies a portfolio allocation would benefit from tail risk hedges including gold, the US dollar and developed market government bonds. With respect to the last, we are cautious as they appear to be somewhat overpriced.

### What actions have we taken in Global Balanced Risk Control (GBaR) portfolios?

We have reduced risk to protect our portfolios and are using options to hedge tail risk. We have recently experienced pronounced tail risk, in an environment of otherwise benign volatility. This tail risk is not only attributable to the impact of COVID-19, but also for example, associated with US-China trade negotiations. Therefore during the last months of 2019, to help protect GBaR portfolios from tail risks, we were relatively cautiously positioned in equities. However, when heightened risk failed to materialise, realised volatility remained low and our relatively low equity exposure meant that we did not capture as much upside as we would have liked.

During 2020, we have implemented an enhanced tail risk hedging strategy incorporating, the use of options. Separate to our market views, this strategy enables us to have an equity weight more consistent with the mid-point of the volatility target ranges of our portfolios, whilst being confident that the tail risks are suitably hedged.

The strategy is not only designed to hedge portfolios against potential downside and tail risk by seeking to reduce equity exposure as a result of a sudden drop in equity markets, but also enables a measure of upside participation by increasing equity exposure were equity markets to suddenly rise.

For all our accounts we continue to rely on diversification of traditional assets to manage risk overall, which includes tail risk events.

With respect to the Global Balanced Income Fund, we sell puts to generate income. For this reason we are applying a different options strategy, more appropriate for this fund. This would be with the objective of replicating a similar effect as the MS INV F Funds, but only using call options.

We have provided the latest estimated asset allocation weights of each of our five Luxembourg SICAV funds in the following table, as of 27 February 2020.

	VOLATILITY P.A. <sup>1</sup>	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %
MS INV F Global Balanced Risk Control Fund of Funds (EUR)	4% – 10%	36.6	43.3	3.4	16.7
MS INV F Global Balanced Income Fund (EUR)	4% – 10%	45.3	40.3	3.6	10.8
MS INV F Global Balanced Fund (EUR)	4% – 10%	40.0	41.5	3.4	15.1
MS INV F Global Balanced Defensive Fund (EUR)	2% – 6%	16.8	62.7	2.9	17.6
MS INV F Multi-Asset Risk Control Fund (USD)	4% - 10%	36.9	53.4	3.5	6.2

Source: Global Balanced Risk Control team, Morgan Stanley Investment Management.

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<sup>1</sup> Volatility targets are indicative ranges. There is no assurance that these targets will be attained.

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